DAC BEACHCROFT

COVID-19 and Financial Distress: Duties and key considerations applicable to all directors

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Businesses are currently facing unprecedented challenges. DAC Beachcroft is advising the NHS on covid-19 issues, as well as many corporate clients on the business issues arising out of the pandemic, particularly in relation to employees, insurance, continuity and cyber security.

This briefing note considers directors' duties. What does a director need to know if their company is facing financial difficulties? Upon reaching the point where liquidation or administration cannot be reasonably avoided, the directors must consider when to cease trading. A director who continues with normal trading past that point may be liable for wrongful or (more unusually) fraudulent trading.

Even in more normal circumstances, it is difficult to identify the precise point in time at which insolvency cannot reasonably be avoided. In the current climate, that has become even harder.

Revenue is down (for many), debtors may be slow to pay, there is uncertainty as to what the next steps in the fight against covid-19 are likely to be and timing as to when restrictions are to be lifted all of which may conspire to increase financial distress on a business. The availability of government help is of course welcome, but how certain is that availability? Do I prolong trading in the hope or expectation of government assistance? Even if I do not believe my business to be solvent? Am I acting in breach of my fiduciary duties if I let employees go in order to reduce my cost base, when the government makes statements suggesting that employees should be protected?

These are difficult questions. The information below is a very brief overview of some practical steps that directors should be taking and a summary of the legal position. It is vital to seek professional advice early. This can help protect directors from personal exposure to being sued or prosecuted. It may also assist the directors in keeping the company trading, where knowledge of the legal position avoids the directors putting the company prematurely into liquidation or administration.

PRACTICALITIES

If there is any concern as to a company's ability to continue to trade, then the directors ought to put in place some or all of the measures below.

1. As an overarching point, all of the steps below (and considerations relating to them) must be carefully recorded. Clear minutes eliminate the possibility for later misinterpretation of a director's actions. They also promote rigour in making the necessary judgments.

2. Regular full board meetings (often these end up being daily) should be called, and properly minuted, so that the financial position of the company can be discussed and the directors can demonstrate that they were acting reasonably at all times.

3. For group companies, the directors should hold separate board meetings for each affected company and must only consider the interests of the relevant company and its creditors.

4. Obtain full and up to date financial information (including detailed cash flow forecasts) so that directors can make informed decisions on the financial position of the company and its future prospects (this has to be monitored in real time as the position become more precarious). Ensure that the company considers the availability of all possible grants and government assistance (see below).

5. Obtain independent financial advice, covering both the immediate and future viability of the company, so that directors can make an informed decision as to whether the company will ultimately survive.

6. Obtain legal advice on directors' duties, availability of government assistance and re-financing possibilities.

7. Hold early discussions with advisors on the need for potential disclosures in Companies House filings, market announcements etc. Be mindful of your disclosure obligations if listed, and note that the FRC provides regular updates

on covid-19 (including what auditors should be reporting on) here.

8. Lastly, consider with your broker whether the circumstances are such that a notification under your Directors & Officers (D&O) insurance is appropriate. D&O policies can provide invaluable cover for legal costs, when directors – individually or as a group – face investigation or are legally exposed to claims in their capacity as directors.

DIRECTORS DUTIES

A director owes a personal duty to promote the success of a company in the interest of all shareholders as a whole. A director should make decisions with the intention to treat all company members fairly, having regard to the impact that the decision will have on employees, the community, the environment, the company's business relationships, and reputation. This changes when a company faces financial distress.

However, there may come a point at which a director knows – or ought to know – that liquidation or insolvency is unavoidable.

At this point, the director's primary duty shifts to protecting the interests of the company's creditors, taking all reasonable steps to prevent increased losses to creditors. The burden of proof is on the director to prove to the courts that this was done.

WRONGFUL TRADING / FRAUDULENT TRADING

A company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

Fraudulent trading is where the business of a company is carried on with the intent to defraud creditors or for any fraudulent purpose. Liability requires some form of dishonesty, and fraudulent trading is a criminal offence.

However, even an honest director can be liable for wrongful trading. The law is interested in the point at which the director knew or ought to have concluded that there was no reasonable prospect of the company avoiding liquidation or administration, even if the director simply made a genuine mistake.

A claim will only likely arise if, on a net basis, it is shown that the company is worse off as a result of the continuation of trading. If there is no increase in the net deficiency of the company's assets over the relevant period then a claim will not be pursued.

Having sufficient cash flow and an ability to pay debts as and when they fall due is a measure of solvency, but directors also need to be aware of the future financial prospects of the company. Making a prediction on future trading and solvency is difficult in the current climate and many directors will be facing the same challenges. In an uncertain economic climate, directors should be making every effort to demonstrate that they have considered the financial position of the company and fully recorded those deliberations.

If forecasts do show potential insolvency it does not necessarily mean that directors should automatically take the decision to cease trading. There are a number of situations where it may be appropriate for the company to continue trading so to improve the position for the creditors, even if insolvent liquidation or insolvent administration is unavoidable. For example, completing a major contract or making a delivery may have the effect of improving the return to creditors. A decision to cease trading prematurely can (perversely) create the same personal liability as a decision to continue trading beyond the point of no return.

A director could also face director's disqualification proceedings, leading to him being unable to act as a director for a period of time, if a liquidator concludes that his conduct makes him unfit to be a director and reports accordingly to the Secretary of State. In this note, we identify steps which if taken will reduce these risks. It is vital that advice is taken early on and steps are taken

TRANSACTIONS IN AN INSOLVENCY SITUATION

It is important that a director faced with the prospect of formal insolvency / liquidation does not show preference to certain creditors over others. For instance, the company should not continue to trade by taking out debt with new creditors in order to pay pre-existing creditors with the intent of improving their position in the event of a formal insolvency.

Preferring one creditor over another can give rise to personal liability and may harm a director's defence if accused of fraudulent / wrongful trading, or if directors disqualification proceedings are pursued.

In addition to wrongful and fraudulent trading, the following broad categories of transaction can be challenged once a company has entered formal insolvency:

Transaction at an undervalue - This is when a company, at any point in the two years before entering insolvency sells assets/ goods / services at an obviously lower price than their true value (including giving them away for nothing).

Preference transaction - When a company gives disproportionate preferential treatment to certain creditors in the six months prior to insolvency (or within the two years prior to insolvency if the recipient of preferential treatment is connected to the company).

Extortionate credit transaction - Where the company entered into a transaction within the three years prior to insolvency, under which the company was to receive credit, but which: (i) required grossly exorbitant payments, and / or (ii) otherwise grossly contravened the principles of fair dealing.

Transaction defrauding creditors - A transaction intended to put assets beyond the reach of the creditors who are entitled to them.

CURRENT POSITION ON GOVERNMENT ASSISTANCE

This information is dated as at 23 March 2020. You should continue to monitor the situation (and as of today the Government has provided a webpage which summarises all forms of support which are available to businesses here). DAC Beachcroft also publishes regular updates as to the types of help available here.

Small and Medium Businesses - The level of borrowing guarantees for SMEs has been increased to £5 million. In addition there will be an interest "holiday" for the first six months of any loan a business takes out as a result of the impact of the Covid-19. Loans can be provided by any accredited lender which includes most banks.

Large Businesses - The Bank of England has launched a major new scheme (the Covid-19 Corporate Financing Facility) which involves the Bank of England buying short term debt from larger companies. This is designed to support companies which are fundamentally strong, but have been affected by a short-term funding squeeze. The aim is to support corporate finance markets overall and ease the supply of credit to all firms.

Retail and Leisure - The sector which has seen the first impact of the Covid-19 will be eligible for grants of up to £25,000 in addition to rate relief and access to the Coronavirus Business Interruption Loan Scheme. The grants will be administered by Local Authorities.

Tax Relief - Various tax reliefs have been provided including Statutory Sick Pay Rebate, Time to Pay, (for businesses in financial distress) and VAT Deferral. The proposed redrafting of the IR35 tax relief has been postponed for a year. It should also be noted that whilst these initiatives (with the exception of sick pay) are very similar to initiatives instigated in 2008, it is possible that the Government may introduce other similar initiatives such as Transitional Loan Funds and/or grant schemes.

EU Measures - The EU Commission has issued a Temporary Framework for small amounts of compatible aid meaning that, subject to some light touch due diligence, governments (including the UK) can give grants of up to €500,000 to businesses in difficulty which is very similar to the scheme introduced during the financial crisis. The EU Commission has also released £140 million for research on vaccines, diagnosis and treatment.

Support for Community Charities - It is anticipated that the National Emergencies Trust will be launching an appeal imminently to raise funds to support local charities affected by covid-19 and that the fund will be administered by Community Foundations. A number of Community Foundations have already launched funds. For more information click here.

Changes to insolvency law - The Government has announced a number of initiatives designed to assist companies in dealing with financial pressures arising from COVID-19 issues.

There will be a temporary suspension of wrongful trading provisions with a view to allowing directors to continue to trade through the pandemic emergency without the fear of personal liability should the company fail. The suspension will apply retrospectively from 1 March but the detailed provisions, including the manner in which the suspension will apply, are unlikely to be published for several weeks as Parliament is in recess until 21 April. The suspension should be welcomed by directors, although the delay in announcing the detail means those who are facing issues now will continue to feel exposed. The fact of the proposed legislation will nevertheless be a factor to take into account when considering whether continuing trading risks wrongful trading.

There will also be new restructuring tools to include a moratorium for companies to give them breathing space from creditors enforcing debts, protection of supplies to allow continued trading through the moratorium and a new restructuring plan to which creditors can be bound. These tools stem from a consultation in May 2016 and proposals which the Government issued in August 2018 and it seems that the current crisis has prompted the introduction of legislation to implement the new tools sooner that would otherwise have been the case.

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